

GAO

Testimony

Before the Subcommittee on National Security,  
Emerging Threats, and International Relations;  
Committee on Government Reform, House of  
Representatives

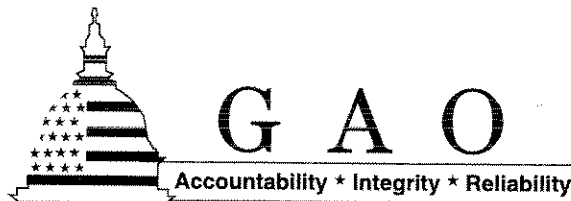
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For Release on Delivery  
Expected at 10:00 a.m.  
Tuesday, April 25, 2006

# REBUILDING IRAQ

## Governance, Security, Reconstruction, and Financing Challenges

Statement of David M. Walker  
Comptroller General of the United States





Highlights of GAO-06-697T, a testimony before the Committee on Government Reform, Subcommittee on National Security, Emerging Threats, and International Relations; House of Representatives

## Why GAO Did This Study

The United States, along with coalition partners and various international organizations, has undertaken a challenging and costly effort to stabilize and rebuild Iraq following multiple wars and decades of neglect by the former regime. This enormous effort is taking place in an unstable security environment, concurrent with Iraqi efforts to transition to its first permanent government.

In November 2005, the President issued the National Strategy for Victory in Iraq. According to the strategy, victory will be achieved when Iraq is peaceful, united, stable, secure, well integrated into the international community, and a full partner in the global war on terror.

In this testimony, GAO discusses the key challenges that the United States, international community, and Iraq face in rebuilding and stabilizing Iraq.

This statement is based on four reports GAO has issued to the Congress since July 2005 and recent trips to Iraq. Since July 2005, GAO issued reports on (1) the status of funding and reconstruction efforts in Iraq, the progress achieved, and challenges faced in rebuilding Iraq's infrastructure; (2) U.S. efforts in the water and sanitation sector; and (3) U.S. assistance for the January 2005 Iraqi elections, and (4) U.S. efforts to stabilize the security situation in Iraq (a classified report).

[www.gao.gov/cgi-bin/getrpt?GAO-06-697T](http://www.gao.gov/cgi-bin/getrpt?GAO-06-697T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Joseph A. Christoff at (202) 512-8979 or [christoffj@gao.gov](mailto:christoffj@gao.gov).

## REBUILDING IRAQ

### Governance, Security, Reconstruction, and Financing Challenges

#### What GAO Found

The war in Iraq will not be won by the military alone. Iraq's future requires strong Iraqi leadership, sustained U.S. commitment, and a reengaged international community.

The United States, Iraq, and its partners have made some progress in stabilizing and rebuilding Iraq. Iraqis have voted in increasing numbers, with over 12 million casting votes in the December 2005 election. Over the past year, the number of security forces that the coalition has trained and equipped has increased from about 142,000 to about 242,000. Finally, the United States has completed or has underway about 500 water, oil, and electricity reconstruction projects.

However, this progress is tempered by the overwhelming challenges the coalition faces. First, sectarian divisions delayed the formation of a permanent government and created a political vacuum. Recent events provide some hope that a new government will be formed in the near future. Once formed, the new government will confront the enormous tasks of strengthening government institutions, disbanding the militias, resolving disputes over internal boundaries and oil revenues, addressing corruption, and delivering results to the Iraqi people. Of particular importance is providing the Iraqis with the training and technical assistance needed to run their national and provincial governments. A transparent and accountable government can reduce corruption and deliver results to the Iraqi people.

Second, the security environment continues to be a concern as insurgents demonstrate the ability to recruit, supply, and attack coalition and Iraqi security forces. From 2004 to 2005, attacks against the coalition, Iraqis, and infrastructure increased 23 percent. Since the bombing of a Samarra mosque in February 2006, Iraqis have become increasingly concerned that civil war may break out. The poor security situation in much of Iraq has impeded the development of an inclusive Iraqi government and effective Iraqi security forces.

Third, higher than expected security costs, funding reallocations, and inadequate maintenance have impeded U.S. reconstruction efforts. As of March 2006, oil and electricity production were below pre-war levels and reconstruction goals for oil, electricity, and water had not been met. Iraq produced 2.6 million barrels of oil per day before the war; in 2005, production averaged 2.1 million barrels per day. Production levels alone do not measure the impact of reconstruction efforts. While U.S. efforts have helped Iraq produce more clean water, 60 percent is lost due to leakage and contamination. Continued focus on developing outcome measures is critical to ensure that reconstruction efforts are making a difference in the lives of the Iraqi people.

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss U.S. efforts to stabilize and rebuild Iraq. The United States, along with its coalition partners and various international organizations, has undertaken a challenging and costly effort to stabilize and rebuild Iraq following multiple wars and decades of neglect by the former regime. This enormous effort is taking place in an unstable security environment, concurrent with Iraqi efforts to transition to its first permanent government.

Between fiscal years 2003 and 2005, the U.S. direct financial commitment to securing and stabilizing Iraq grew to \$278 billion. Approximately \$248 billion has been provided to support U.S. military operations and forces, which currently number about 130,000 troops, and about \$30 billion to develop capable Iraqi security forces, restore essential services, and rebuild Iraqi institutions. In February 2006, the administration requested an additional \$123 billion to support U.S. stabilization and reconstruction operations in Iraq and Afghanistan in fiscal years 2006 and 2007.<sup>1</sup> These amounts do not include future direct costs nor do they include the significant, additional recapitalization and other longer-term costs that will be incurred due to the Iraq conflict.

In November 2005, the President issued the National Strategy for Victory in Iraq. According to the strategy, victory will be achieved when Iraq is peaceful, united, stable, secure, well integrated into the international community, and a full partner in the global war on terrorism. The new strategy also aimed to provide a more comprehensive and coordinated focus on U.S. stabilization and reconstruction efforts in Iraq. Success in Iraq requires progress on the three tracks of the President's National Strategy for Victory in Iraq. The strategy states that progress along one of these tracks—political, security, or economic—reinforces progress along the other tracks.

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<sup>1</sup> A separate breakout for Iraq was not provided. For fiscal year 2006, the administration requested \$72.4 billion in supplemental funds, including \$38 billion for defense and intelligence operations in Iraq and Afghanistan, plus \$3.7 billion to develop Iraqi security forces and \$4.2 billion for State to continue its operations in Iraq. For fiscal year 2007, the defense budget request includes \$50 billion that the Office of Management and Budget terms "bridge funding" to continue the global war on terror in Iraq and Afghanistan. State's 2007 budget submission requests an additional \$836 million for reconstruction and embassy operations in Iraq.

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My testimony today is based on the four reports that we have issued to the Congress since July 2005 and on our recent trips to Iraq. Since July 2005, we have reported on (1) the status of funding and reconstruction efforts in Iraq, focusing on the progress achieved and the challenges faced in rebuilding Iraq's infrastructure; (2) U.S. reconstruction efforts in the water and sanitation sector; (3) U.S. assistance for the January 2005 Iraqi elections; and (4) U.S. efforts to stabilize the security situation in Iraq (a classified report).

Based on these four reports and recent audit work conducted in Iraq, including my most recent visit to the country earlier this year, I will discuss the key challenges that the United States, the international community, and the Iraqi government face in stabilizing and rebuilding Iraq. We conducted our reviews for these reports under my authority as Comptroller General in accordance with generally accepted government auditing standards. In addition, we recently completed audit work in Iraq in November 2005, January 2006, and March-April 2006.

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## Summary

The war in Iraq will not be won by the military alone but only through an integrated U.S., Iraqi, and international effort to meet the political, security, economic, and other needs of the Iraqi people.

The United States, our partners, and Iraq have made some progress in stabilizing and rebuilding Iraq. Iraqis have voted in increasing numbers, with over 12 million casting votes in the December 2005 election. The number of security forces that the coalition has trained and equipped has increased from about 142,000 in March 2005 to about 242,000 in March 2006. Finally, the United States has completed or has underway about 500 water, oil, and electricity reconstruction projects.

However, this progress is tempered by the overwhelming challenges faced in forming a permanent government, quelling the insurgency and sectarian violence, providing basic services, and financing future reconstruction efforts.

- Four months after the December 2005, election, Iraq is still forming a permanent government. Sectarian divisions have delayed the formation of a permanent government and created a political vacuum. Recent events provide some hope that a new government will be formed in the near future. Once formed, the new government will confront the enormous tasks of strengthening government institutions, disbanding the militias, resolving disputes over internal boundaries and oil revenues, and

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addressing corruption. Appointments to the key ministries of Interior, Defense, and Oil will be critical to unifying Iraq and minimizing sectarian violence. As the new government develops, the Iraqis will need assistance and training to strengthen their national and provincial governments. A transparent and accountable government will reduce corruption and deliver results to the Iraqi people.

- From 2004 to 2005, attacks against the coalition, Iraqis, and infrastructure increased 23 percent. Despite coalition efforts, insurgents continue to demonstrate the ability to recruit, supply, and attack coalition and Iraqi security forces. In addition, sectarian tensions and violence increased following the February 2006 bombing of a Shi'a shrine in Samarra. Since then, Iraqis have become increasingly concerned that civil war may break out. Many Iraqis in Baghdad and the central and northern Sunni areas have lost confidence in the Iraqi army and police to improve the security situation. In some Sunni areas, support for the insurgents has increased, and Iraqi Shi'as have expressed greater confidence in their militias. The poor security situation in Iraq has impeded the development of an inclusive Iraqi government and hindered the development of effective Iraqi security forces.
- U.S. reconstruction efforts have focused on restoring Iraq's basic services, including refurbishing oil facilities, increasing electrical generating capacity, and rebuilding water treatment plants. As of March 2006, oil and electricity production were below pre-war levels and reconstruction goals for oil, electricity, and water had not been met. Iraq produced 2.6 million barrels of oil per day before the war; in 2005, production averaged 2.1 million barrels per day. Higher than expected security costs, funding reallocations, and inadequate maintenance have slowed the pace of reconstruction efforts and limited the impact of the services provided. For example, in the water sector, \$1.9 billion was reallocated to the security and justice sectors, which delayed or terminated many large water projects. In addition, production levels alone do not measure the impact of reconstruction efforts. While U.S. efforts have helped Iraq produce more clean water, 60 percent is lost due to leakage and contamination. Continued focus on developing outcome measures is critical to ensure that U.S. efforts are making a difference in the lives of the Iraqi people.
- Iraq will likely need more than the \$56 billion originally estimated for reconstruction and stabilization efforts, but it is unclear how Iraq will finance its reconstruction needs. U.S. commitments are largely obligated, and future commitments focus on sustaining existing infrastructure, strengthening ministerial capacity, and training and equipping Iraqi security forces. International donors are reluctant to commit additional

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funds until security improves and Iraq accounts for the donors' previous contributions. Iraq can only contribute to its future reconstruction needs if it increases oil revenues, reduces energy and food subsidies, controls government operating expenses, and minimizes corruption.

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## Background

From May 2003 through June 2004, the CPA, led by the United States and the United Kingdom, was the UN-recognized coalition authority responsible for the temporary governance of Iraq and for overseeing, directing, and coordinating the reconstruction effort. In May 2003, the CPA dissolved the military organizations of the former regime and began the process of creating or reestablishing new Iraqi security forces, including the police and a new Iraqi army. Over time, multinational force commanders assumed responsibility for recruiting and training some Iraqi defense and police forces in their areas of responsibility. The U.S.-led Multi-National Force-Iraq (MNF-I) conducts counterinsurgency operations and leads coalition efforts to train, equip, and organize Iraqi security forces.

The Department of State (State) is responsible for all U.S. activities in Iraq except security and military operations. State's Iraq Reconstruction and Management Office (IRMO) is responsible for planning and prioritizing reconstruction requirements, monitoring spending, and coordinating with the military commander. Other U.S. government agencies also play significant roles in the reconstruction effort. The U.S. Agency for International Development (USAID) is responsible for projects to restore Iraq's infrastructure, support healthcare and education initiatives, expand economic opportunities for Iraqis, and foster improved governance. The U.S. Army Corps of Engineers provides engineering and technical services to USAID, State, and military forces in Iraq. In December 2005, the responsibilities of the Project Contracting Office (PCO), a temporary organization responsible for program, project, asset, and financial management of construction and nonconstruction activities, were merged with those of the U.S. Army Corps of Engineers.

On June 28, 2004, the CPA transferred power to an interim sovereign Iraqi government, the CPA was officially dissolved, and Iraq's transitional period began. Under Iraq's transitional law, the transitional period included the completion of a draft constitution in October 2005 and two subsequent elections—a referendum on the constitution and an election for a permanent government. The Iraqi people approved the constitution on October 15, 2005, and voted for representatives to the Iraq Council of

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Representatives on December 15, 2005. The Independent Electoral Commission of Iraq certified the election results on February 10, 2006.

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## Iraq Has Made Some Progress in Political, Security, and Economic Areas

The Iraqi government, in partnership with the United States and others, has made some progress in rebuilding and stabilizing Iraq. Since June 2004, Iraqis have approved a new constitution and increasingly participated in the process of forming the first permanent government under this constitution. The United States has helped train and equip a growing number of Iraqi security forces, and these forces have taken on increasing responsibility for the nation's security. Iraq's economy is growing and the United States has completed a number of projects to help Iraq add to, maintain, or refurbish its electrical, water supply, and oil production capacity. Although making progress in many areas, Iraq has also had setbacks.

## Iraqis Have Increasingly Participated in the Political Process

The U.S. goal is to work with the Iraqi government to form a permanent national unity government that is inclusive. According to the UN Secretary General, Iraq has met all key benchmarks for transitioning to a permanent government under Security Council Resolution 1546.<sup>2</sup> In January 2005, Iraqis elected a transitional National Assembly. Despite intimidation and threats of violence, almost 8.5 million Iraqis (59 percent of those registered) cast ballots and elected the assembly. In October 2005, the transitional government endorsed a draft constitution that, according to the U.S. ambassador for Iraq, protects human rights, religious freedom, women's equality and Iraqi unity. Iraqis approved the constitution, with nearly 10 million voters casting ballots (68 percent of those registered). Then, in December 2005, over 12 million Iraqis (79 percent of those registered) voted to elect the first Council of Representatives. According to the National Security Council's Director for Iraq, the increasing participation of all Iraqis in the political process, especially Sunnis, demonstrates significant political progress. However, the majority of Iraqis voted along sectarian lines.

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<sup>2</sup>U.N. Security Council Resolution 1546 endorsed a timetable for Iraq's transition to a democratic government which included drafting a permanent constitution for Iraq leading to a constitutionally elected government by December 31, 2005.

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## Iraqi Forces Are Increasingly Responsible for the Nation's Security

U.S. goals are to defeat the terrorists and neutralize the insurgency, develop capable Iraqi security forces, and help the government advance the rule of law, deliver services, and nurture civil society. Over the last several months, the Secretaries of State and Defense, as well as MNF-I, reported progress in developing Iraqi security forces, saying that these forces continue to grow in number, take on more responsibilities, and increase their lead in counterinsurgency operations. The numbers of operational army personnel and trained and equipped police have increased from about 142,000 in March 2005 to about 242,000 in March 2006. However, as we have previously reported, the number of trained and equipped forces does not provide information on their capabilities. DOD reports the capabilities of Iraqi units using transition readiness assessments. This information is provided to the Congress in quarterly classified reports.

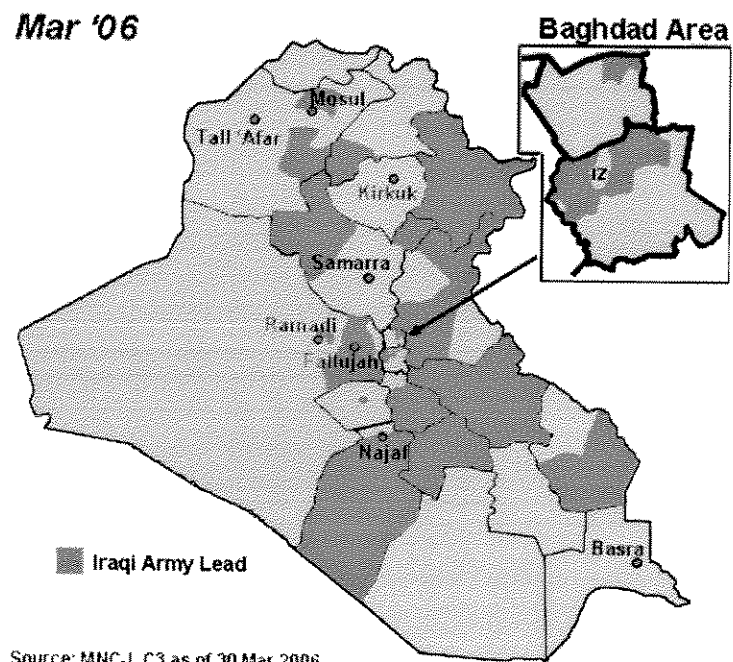
In April 2006, MNF-I also reported that 52 Iraqi army battalions, 14 Iraqi Army brigades, and 2 Iraqi Army divisions had taken the lead for counterinsurgency operations, with coalition support in areas of Iraq shown in figure 1 below. The Administration reports that these areas of operation cover about 18 percent of Iraq's territory, including about 65 percent of Baghdad.<sup>3</sup> According to the Director for National Intelligence, Iraqi security forces are taking on more-demanding missions, making incremental progress toward operational independence, and becoming more capable of providing security.

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<sup>3</sup>Six National Police battalions also conduct counterinsurgency operations in Baghdad.



Fig. 1: Areas of Iraq Where the Iraqi Army Leads Counterinsurgency Operations with Coalition Support, as of March 30, 2006



Source: MNF-I Iraq Operational Update Briefing, April 13, 2006.

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However, according to a DOD report, Iraqi army units remain largely dependent on coalition support for key logistics and other combat enablers such as transportation and communications. Several problems have hampered the Ministry of Defense's ability to sustain Iraqi forces independently, including weaknesses in payroll, material readiness, contracting, and construction. Furthermore, although a concept of logistical support exists, the Iraqi army will continue to rely on a U.S. supply chain because Iraq does not have a defense industrial base.

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### **Iraq's Economy Is Growing and Projects Seek to Improve Essential Services**

The U.S. economic goal in Iraq is to help the Iraqi government establish the foundations for a sound economy with the capacity to deliver essential services. The economy continues to grow; the International Monetary Fund estimated that Iraq's GDP in 2005 grew by 2.6 percent and estimates that it will grow by 10.4 percent in 2006. While the Iraqi economy continues to be overwhelmingly dependent on oil exports, which accounted for over 95 percent of government revenue in 2005, other sectors have begun to pick up activity, including the trade and services sector. According to State and DOD reporting, the United States has completed or has underway about 500 water, oil, and electricity reconstruction projects. These projects have added or restored more than 2,700 megawatts of electricity generation capacity and improved other essential services. U.S. efforts have helped to restore Iraq's oil production and export capacity, including the restoration of the Qarmat Ali water reinjection and treatment plant, and several gas and/or oil separation plants near Kirkuk and Basrah. However, crude oil production and export and electricity production levels remain below pre-war levels.

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### **The Iraqi Government and the United States Face Key Challenges to Stabilizing and Rebuilding Iraq**

The United States and Iraq must address four key challenges if they are to successfully stabilize and rebuild Iraq. First, Iraq needs to form a permanent government. Second, Iraq and the United States must neutralize the insurgency and address sectarian violence. Third, the Iraqi government and the United States must restore and maintain basic services. Fourth, Iraq must secure funding to continue reconstruction efforts begun by the United States.

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## Sectarian Divisions and Immediate Challenges Will Confront Iraq's Permanent Government

Forming a permanent government in Iraq is critical to defeating the insurgency and securing the peace. However, sectarian divisions delayed the formation of a permanent government and created a political vacuum. Recent events provide some hope that a new government will be formed in the near future. Once formed, the new government will face four immediate challenges: building effective national and provincial governments, stemming corruption, disbanding militias, and resolving disputes on boundaries and ownership of future oil fields.

## Sectarian Divisions Delay Government Formation

Sectarian divisions delayed formation of Iraq's permanent government creating a political vacuum that increases the risk that terrorists and former regime elements will succeed in stopping Iraqi progress toward democracy. According to the Defense Intelligence Agency (DIA) Director, the December 2005 elections appeared to have heightened tension and polarized sectarian divides. In February, the Kurdish parties' nomination of Jalal Talabani to be president of Iraq was not challenged by other Iraqi parties. However, Shi'a, Kurdish and Sunni parties could not agree on a prime minister. In this regard, the Secretary of State emphasized that the prime minister had to be a leader who could be a unifying force bringing stability to the nation.

In February 2006, the holy Shi'a shrine in Samarra was bombed, intensifying sectarian conflicts. The bombing provoked violence and reprisal attacks in Baghdad, Basra, and other urban centers and almost daily reports of sectarian intimidation and murder, according to the UN. During March and April, the Iraqi parties continued efforts to identify a prime minister and a cabinet. On April 22, Iraq's legislative body selected their speaker and the Presidency Council. Also, a candidate for prime minister was nominated with support of the Sunnis, Kurds, and Shia coalition.

According to the President of the United States, Iraq's leaders have 30 days to finalize the Iraqi cabinet. Among the ministries of key concern are Interior, Defense, and Oil, according to State officials. The Ministry of Interior was seriously compromised by sectarian influences of militias, corruption, and a culture of impunity, according to State's 2006 human rights report. Defense is responsible for the Iraqi military services, plays a primary role in stabilizing the country, and has over 100,000 forces. The Ministry of Oil generates about 90 percent of the Iraq government's revenue and is the focus of considerable concern regarding oil smuggling and corruption.

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**Iraq's Government Faces Four  
Major Challenges to Unifying  
the Nation**

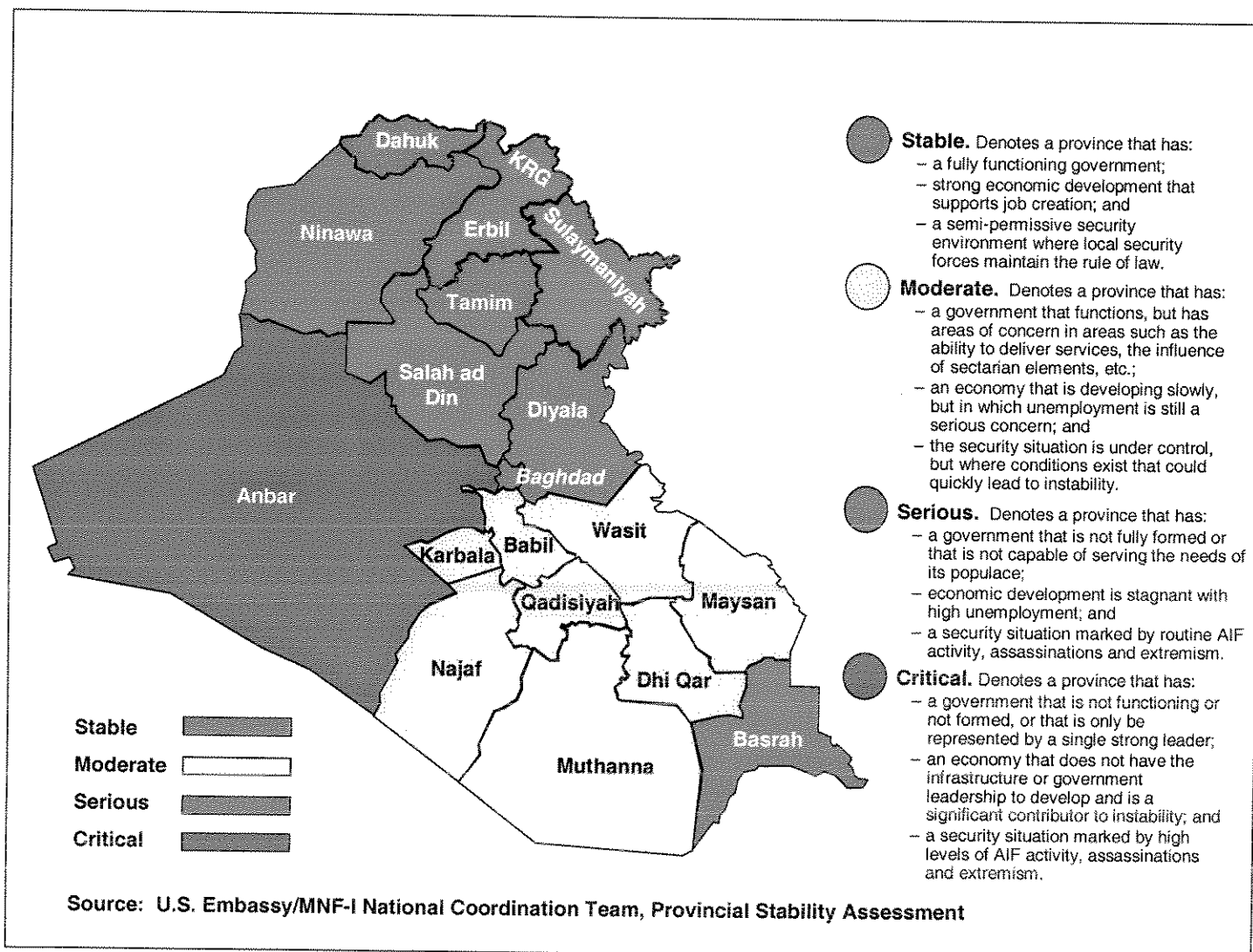
The new government will face four immediate challenges once formed.

**Developing effective national and provincial governments.**

Strengthening national and provincial institutions is a key step in improving governance and supporting efforts to build Iraqi self-reliance and defeat the insurgency. However, according to U.S. assessments, Iraqi ministries have limited capacity to provide government services to the Iraqi people. These assessments identified limitations in managers' skills and training; weak technical expertise; outdated work processes and procedures; and an inability to identify and articulate strategic priorities. In January 2006, State reported a new initiative to address Iraqi ministerial capacity development at 10 national ministries. According to State, Embassy Baghdad plans to undertake plans to provide key ministries with training in civil service policies, requirements-based budget processes, information technology standards, and logistics management systems.

In addition to a weak national government, Iraqi provinces also have limited capacity to provide governmental services. A March 2006 joint U.S. embassy and MNF-I assessment of stability in each of Iraq's 18 provinces showed varying levels of stability across Iraq's 18 provinces (see fig. 2).

Figure 2: Iraq Provincial Stability Based on Governance, Security, and Economic Conditions, as of March 2006



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As figure 2 illustrates, the three provinces in Kurdistan have fully functioning governments, strong economies, and relative security. Eight provinces have functioning governments with problems in delivering services and dealing with security. The remaining seven provinces are in serious or critical condition, with Anbar province rated as critical.

To help build government capacity at the provincial level, the U.S. embassy in Baghdad and MNF-I are developing provincial reconstruction teams (PRTs). These teams are designed to provide a link between provincial and national level efforts to improve governance. These teams are charged with helping provincial governments improve security, rule of law, and political and economic development. State officials said that U.S.-led PRTs in Hillah, Mosul, and Kirkuk have been fully operational since December. Another PRT in Baghdad has been initiated but is not yet fully operational. The anticipated four other U.S.-led, four coalition-led, and six Iraqi-led PRTs have not been initiated. Each PRT requires more than 100 staff and considerable financial and security support. However, program documents indicate problems in providing funding and security.

**Stemming corruption.** U.S. and international officials reported increased concerns about corruption. In our discussions with IMF, World Bank, Japan, and the European Union, several representatives reported that “donor fatigue” might limit their ability to provide future assistance to Iraq, especially if the current security environment did not improve and the Iraqi Ministries did not improve their procurement and financial management practices. Corruption in the oil sector was cited as a special problem. According to State officials and reporting, about 10 percent of refined fuels are diverted to the black market, and about 30 percent of imported fuels are smuggled out of Iraq and sold for a profit.

According to World Bank and UN specialized agency officials, public tendering is still an “alien concept” within Iraq Ministries. These officials reported several recent attempts by Ministry officials to subvert the public procurement process. For example, World Bank financing for two projects worth \$40 million each was cancelled after Iraqi ministry officials awarded contracts to firms that were not included in the competitive bidding process.

U.S. officials also reported instances of corruption related to the protection of essential infrastructure. According to IRMO officials, the Ministry of Electricity contracts with tribal chiefs, paying them about \$60-\$100 per kilometer to protect transmission lines running through their areas. However, IRMO officials reported that the protection system is

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flawed and encourages corruption. According to U.S. and UN Development Program officials, some tribes that are paid to protect transmission lines are also selling materials from downed lines and extracting tariffs for access to repair the lines. IRMO officials stated that they want the Ministry of Electricity to change the system so that tribes are only paid when the lines remain operational for a reasonable period of time.

**Disbanding militias.** Disbanding the militias or integrating them into Iraq's armed forces is a critical challenge facing a new Iraqi government. Iraq's 2004 transitional law outlawed all militias not under the command structure of the Iraqi transitional government, except where provided by federal law. Iraq's constitution similarly states that formation of military militias outside the framework of the armed forces is prohibited. Despite these prohibitions, militias continue to operate throughout Iraq. The largest militias include the Kurdish Peshmerga organization in Kurdistan, the Shiite Badr organization in southern Iraq, and the Shiite Jayash al-Mahdi (Mahdi Army) in central and southern Iraq. In March 2006, the UN reported that militias challenge Iraq's rule of law and that the consolidation of local militia power in southern Iraq is resulting in systematic acts of violence against the Sunni community.<sup>4</sup> Such developments, including recent efforts to form a Sunni Arab militia could undermine efforts to promote national accord. According to the Secretary of State, controlling the militias is one of the new government's top priorities.

**Resolving disputes on boundaries and ownership of future oil fields.** Resolving disputes over territorial boundaries, especially in Kirkuk, poses another challenge. The Kurds believe that this oil-rich region is part of the Kurdish regional government's territory. According to the 2003 State Department Human Rights report, the previous regime had systematically forced the removal of ethnic minorities under its admitted policy of "Arabizing" arable land. Specifically, the regime "Arabized" certain Kurdish areas, such as the urban centers of Kirkuk and Mosul, through the forced movement of local residents from their homes and villages and their replacement by Arabs from outside the area. According to State, resolution of the dispute over Kirkuk is an issue that needs to be addressed.

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<sup>4</sup>U.N. Security Council, Report of the Secretary General pursuant to paragraph 30 of resolution 1546 (2004), S/2006/137, Mar. 3, 2006.

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In addition, a new Iraqi government will need to agree on how to share the proceeds from crude oil exports from both current and future Iraqi oil fields. The constitution states that oil and gas are owned by the people of Iraq in all regions and governorates. It also states that the federal government, with the producing governorates and regional governments, shall undertake the management of oil and gas extracted from the present fields, provided that it distributes its revenues fairly and in proportion to the population.<sup>6</sup> However, the specific details of revenue sharing have yet to be worked out, and the status of revenues from future fields is unclear.

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**A Strong Insurgency and Increased Sectarian Violence Threaten Progress in Political and Security Areas**

Over the past 3 years, significant increases in attacks against the coalition and coalition partners, as well as recent increases in sectarian violence, have made it difficult for the United States to achieve its political and security goals in Iraq. The insurgency in Iraq intensified from June 2003 through October 2005 and has remained strong and resilient. Sectarian tensions and violence recently increased following the bombing of a holy Shi'a shrine in Samarra in February 2006. Poor security conditions threaten to undermine the development of an effective Iraqi government and the transfer of security responsibilities to the Iraqi government.

**Insurgency Has Intensified and Sectarian Tensions Increased**

The insurgency intensified through October 2005 and has remained strong and resilient since then. The insurgency—particularly the Sunni insurgency—grew in complexity, intensity, and lethality from June 2003 through early 2005.<sup>6</sup> According to a late February 2006 testimony by the Director of National Intelligence, insurgents are using increasingly lethal improvised explosive devices and continue to adapt to coalition countermeasures.<sup>7</sup>

As shown in figure 3, enemy-initiated attacks against the coalition, its Iraqi partners, and infrastructure increased in number over time. The highest

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<sup>6</sup>The constitution also states that the federal government shall specify an allotment of the oil revenue “for a specified period for the damaged regions which were unjustly deprived of them by the former regime, and the regions that were damaged afterwards in a way that ensures balanced development in different areas of the country.”

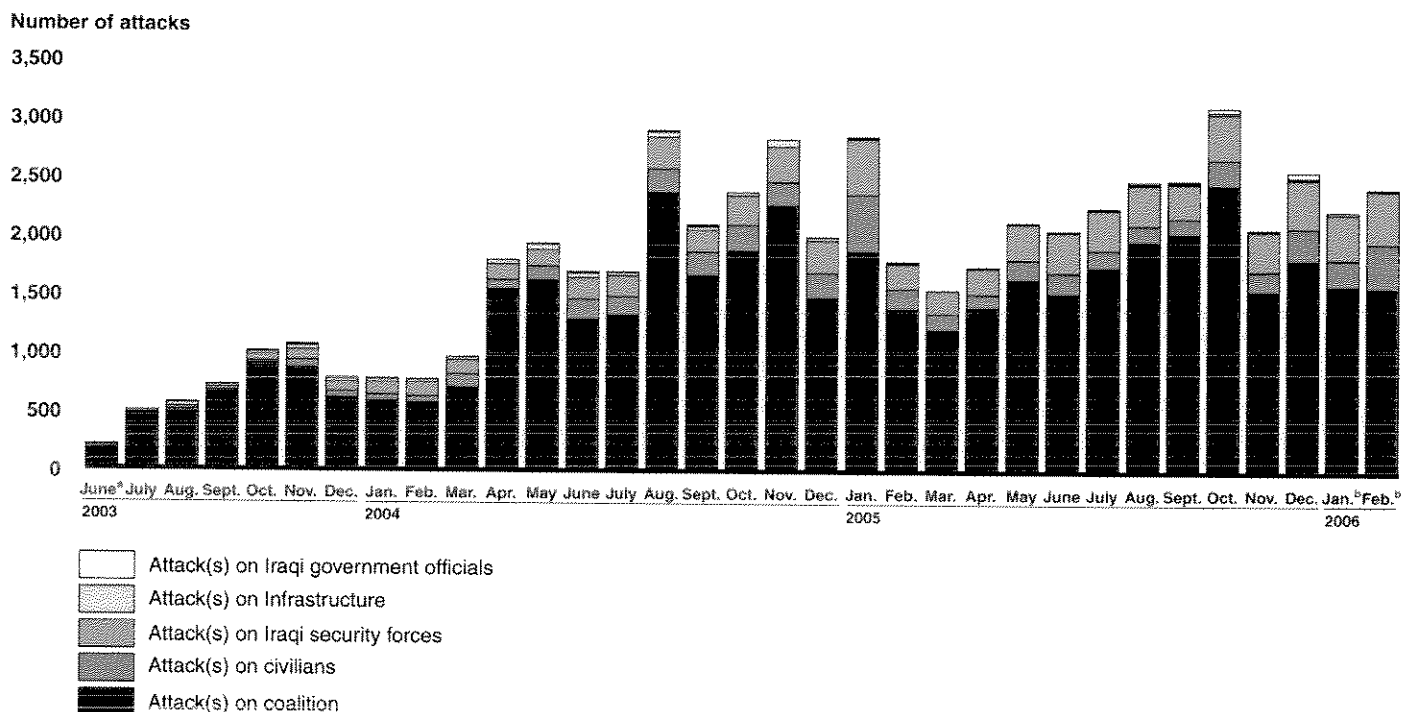
<sup>6</sup>For more information on security trends and the makeup of the insurgency, see GAO, *Rebuilding Iraq: Preliminary Observations on Challenges in Transferring Security Responsibilities to Iraqi Military and Police*, GAO-05-431T (Washington, D.C.: Mar. 14, 2005).

<sup>7</sup>U.S. Senate, Senate Armed Services Committee, *Current and Projected National Security Threats to the United States* (Washington, D.C.: Feb. 28, 2006).



peak occurred during October 2005, around the time of Ramadan and the October referendum on Iraq's constitution. This followed earlier peaks in August and November 2004 and January 2005. According to a senior U.S. military officer, attack levels ebb and flow as the various insurgent groups—almost all of which are an intrinsic part of Iraq's population—rearm and attack again. Overall, attacks increased by 23 percent from 2004 to 2005.

**Figure 3: Enemy-Initiated Attacks against the Coalition and Its Partners, by Category, June 2003 through February 2006**



Source: Multi-national Corps-Iraq, Multi-national Force-Iraq, February 2006.

<sup>a</sup>According to DIA officials, June 2003 data are incomplete.

<sup>b</sup>The data did not break out attacks against Iraqi government officials from attacks against Iraqi civilians in January and February 2006.

According to a March 2006 UN report, an increasingly complex armed opposition continues to be capable of maintaining a consistently high level of violent activity across Iraq. Baghdad, Mosul, and the western province of Al Anbar have been experiencing the worst violence. Although the southern and northern governorates are less affected, some areas, particularly Basra and Kirkuk, have recently witnessed increased tension and a growing number of violent incidents. A recent U.S. embassy-MNF-I

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assessment showed that, of Iraq's 18 provinces, 1 province—Al Anbar—had a security situation marked by a high level of insurgent activity, assassinations, and extremism; 6 provinces, including Baghdad and Basra, had routine insurgent activity, assassinations, or extremism; 8 provinces had the security situation under control but conditions existed that could quickly lead to instability; and 3 provinces in the north had a semi-permissive security environment where local security forces maintained the rule of law.

As the administration has reported, insurgents share the goal of expelling the coalition from Iraq and destabilizing the Iraqi government to pursue their individual and, at times, conflicting goals.<sup>8</sup> Iraqi Sunnis make up the largest portion of the insurgency and present the most significant threat to stability in Iraq. In February 2006, the Director of National Intelligence reported that the Iraqi Sunnis' disaffection is likely to remain high in 2006, even if a broad, inclusive national government emerges. These insurgents continue to demonstrate the ability to recruit, supply, and attack coalition and Iraqi security forces. Their leaders continue to exploit Islamic themes, nationalism, and personal grievances to fuel opposition to the government and recruit more fighters.

According to the Director of National Intelligence, the most extreme Sunni jihadists, such as al-Qaeda in Iraq, will remain unreconciled and continue to attack Iraqi and coalition forces. The remainder of the insurgency consists of radical Shi'a groups—some of which are supported by Iran—violent extremists, criminals, and, to a lesser degree, foreign fighters. According to the Director, Iran provides guidance and training to select Iraqi Shi'a political groups and weapons and training to Shi'a militant groups to enable anticoalition attacks. Iran also has contributed to the increasing lethality of anticoalition attacks by enabling Shi'a militants to build improvised explosive devices with explosively formed projectiles, similar to those developed by the Lebanese Hizballah.

According to the March 2006 UN report, the deteriorating security situation is further evidenced by the increased levels of sectarian strife and the sectarian nature of the violence, particularly in ethnically mixed areas of Iraq. The UN expressed concern about the role of militias and irregular armed elements in the almost daily reports of intercommunal

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<sup>8</sup>Department of Defense, Report to Congress, Measuring Stability and Security in Iraq, July 20, 2005. National Security Council, National Strategy for Victory in Iraq, November 2005.

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Poor Security Conditions  
Hinder Development of  
Political and Security  
Institutions

intimidation and murder. These include regular reports of bodies of Sunni and Shi'a men with signs of torture and summary execution in Baghdad and its surrounding areas. Violence against Kurds and Arabs has also been reported in Kirkuk, while the abduction and intimidation of ordinary Iraqis is a growing problem. According to the report, repeated bombings against civilians, mosques, and more recently against churches are creating fear, animosity, and feelings of revenge within Iraq's sectarian communities.

According to UN and U.S. reports, the continuing insurgency and recent increase in sectarian violence have impeded the development of an effective, inclusive Iraqi government. In March 2006, the UN reported that persistent attacks and terrorist actions by armed groups against the Iraqi government in large parts of the country challenged the stability of the country and the government's ability to protect its citizens. According to a late February 2006 State Department survey, Iraqis have become increasingly concerned that civil war may break out. Iraqis in Baghdad and the central and northern Sunni areas have lost confidence in the ability of Iraqi army and police to improve the security situation. At the same time, support for the armed resistance increased in some Sunni areas, and Iraqis in Shi'a areas expressed confidence in two large Shi'a militias, the Badr Organization and the Mahdi Army. In early April 2006, the State Department reported that the recent terrorist activity and rise in sectarian violence impeded efforts to further the understanding and trust between political groups necessary to establish a government of national unity. The report noted the importance of Iraq developing ministries that sectarian interests do not control.

Recent U.S. reports have recognized that the security situation has the potential to hinder progress in developing effective Iraqi security forces, thereby delaying the transfer of security responsibilities to the Iraqi government and the drawdown of U.S. forces. For example, in February 2006, the Director of National Intelligence testified that Iraqi security forces are experiencing difficulty in managing ethnic and sectarian divisions among their units and personnel, while the director of the Defense Intelligence Agency reported that many elements of the Iraqi security forces are loyal to sectarian and party interests. In the November 2005 National Strategy for Victory in Iraq, the administration cited a number of challenges to developing effective Iraqi security forces, including the need to guard against infiltration by elements whose first loyalties are to institutions other than the Iraqi government. Moreover, in March and April 2006, a senior U.S. military officer stated that to help quell sectarian tensions and violence, MNF-I increased the number of coalition

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and Iraqi troops in Baghdad. These troops increased patrols in areas that had been transferred to the Iraqi security forces.

GAO's October 2005 classified report and recent classified briefing to your staff provided further information and analysis on the challenges to developing Iraqi security forces and the conditions for the phased drawdown of U.S. and other coalition forces.<sup>9</sup> In response to a Congressional mandate based on our report, the administration reported to Congress additional details on the current U.S. mission and the conditions necessary to transfer security responsibility to the Iraqi government, including criteria used to evaluate progress.<sup>10</sup>

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**Reconstruction Goals Not Yet Reached Because of Security, Management, and Sustainment Challenges**

U.S. reconstruction efforts have focused on restoring basic services in Iraq, such as repairing oil facilities, increasing electricity generating capacity, and restoring water treatment plants. However, key reconstruction goals in the oil, electricity, and water sector have yet to be achieved due to security, management, and sustainment challenges in U.S.-funded projects.

**Key Reconstruction Goals Have Not Been Achieved**

U.S. electricity, oil, and water projects have focused on restoring essential services, such as refurbishing and repairing oil facilities, increasing electrical generating capacity, and restoring water treatment plants but key reconstruction goals have not been achieved (see table 1).

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<sup>9</sup>GAO, *DOD Reports Should Link Economic, Governance, and Security Indicators to Conditions for Stabilizing Iraq*, GAO-06-152C (Washington, D.C.: Oct. 2005).

<sup>10</sup>Department of State, *Report to Congress submitted pursuant to U.S. Policy in Iraq Act, Section 1227 of the National Defense Authorization Act for Fiscal Year 2006 (P.L. 109-163)* (Washington, D.C., April 2006).

**Table 1: Reconstruction Goals Not Met for Oil Electricity and Water Sectors**

| Sector      | Metric                             | Pre-War (2003) | Current (March 2006)              | Planned U.S. end state |
|-------------|------------------------------------|----------------|-----------------------------------|------------------------|
| Oil         | Crude Oil Production Capacity      | 2.6 MBPD       | 2.0 MBPD                          | 3.0 MBPD               |
| Electricity | Peak Generation Capacity           | 4300 MW        | 4,092MW (5387 MW peak in 7/14/05) | 6,000 MW               |
| Water       | New or Restored Treatment Capacity | Unknown        | 1.1 M m3/day                      | 2.5 M m3/day           |

MBPD = millions of barrels per day

MW = megawatts

M m3/day = million cubic meters per day

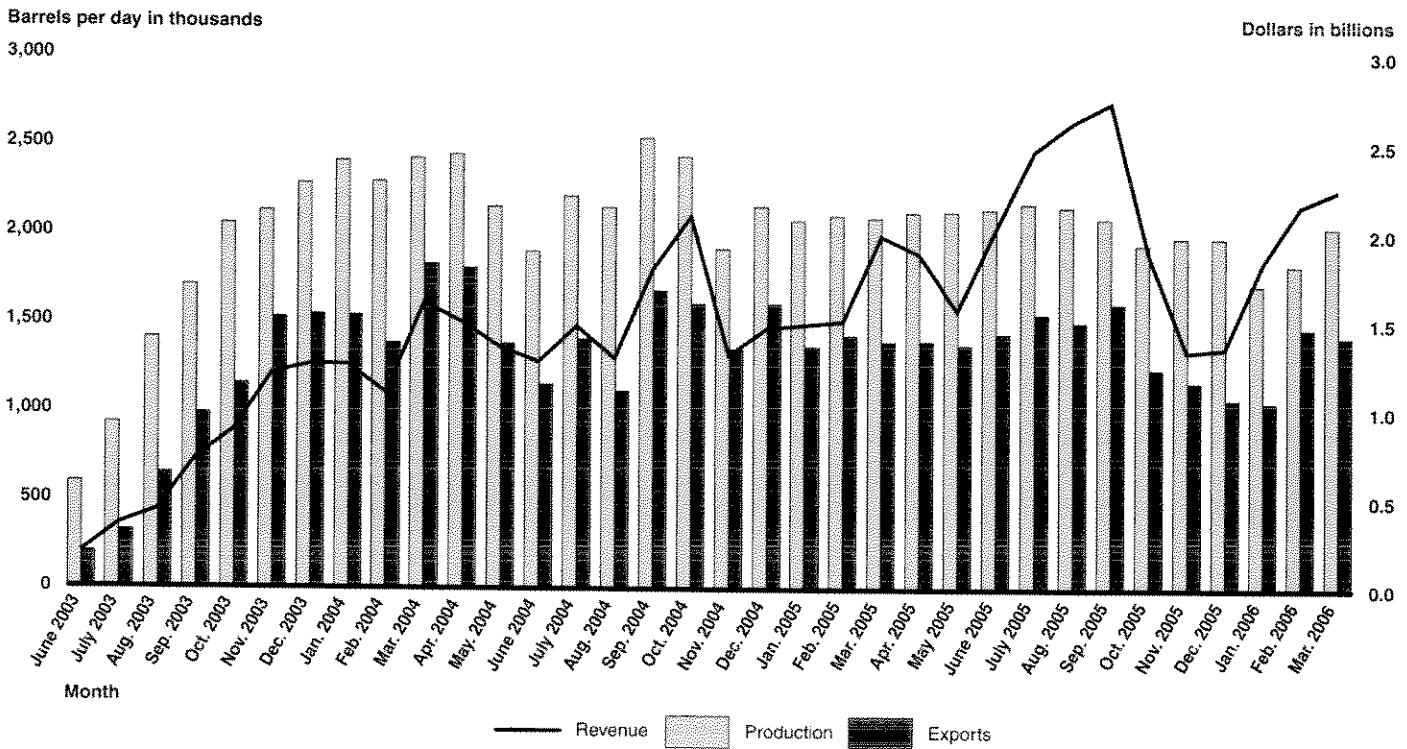
Source: U.S. Embassy Baghdad, "Reconstruction Progress in Iraq," March 29, 2006

As of March 2006, oil, electricity, and water sectors were below the planned U.S. end state. Before the war, oil production in Iraq averaged 2.6 million barrels per day (mbpd). In March 2006, State reported that oil production was about 2 mbpd, significantly below the desired goal of 3 mbpd. A combination of insurgent attacks on crude oil and product pipelines, dilapidated infrastructure, and poor operations and maintenance have hindered domestic refining and have required Iraq to import significant portions of liquefied petroleum gas, gasoline, kerosene, and diesel.

In March 2006, electric generation capacity was about 4,100 megawatts. This level was below the post-war peak of about 5,400 megawatts and the planned U.S. goal of 6,000 megawatts. Insurgent attacks have weakened the grid and the lack of fuel and spare parts has contributed to disruptions in service. In the water sector, the U.S. goal of providing 2.5 million cubic meters of water per day has not been achieved. As of March 2006, only 1.1 million cubic meters of water per day was produced.

Specifically, production levels for oil and electricity have consistently fallen below their respective pre-war levels. As shown in Figure 4, since 2004, oil production levels have consistently averaged below pre-war levels of about 2.6 mbpd. In addition, although the capacity for export is theoretically as high as 2.5 million bpd, export levels averaged about 1.4 million bpd in 2005.

**Figure 4: Iraqi Oil Production, Export, and Revenues, June 2003 through March 2006**

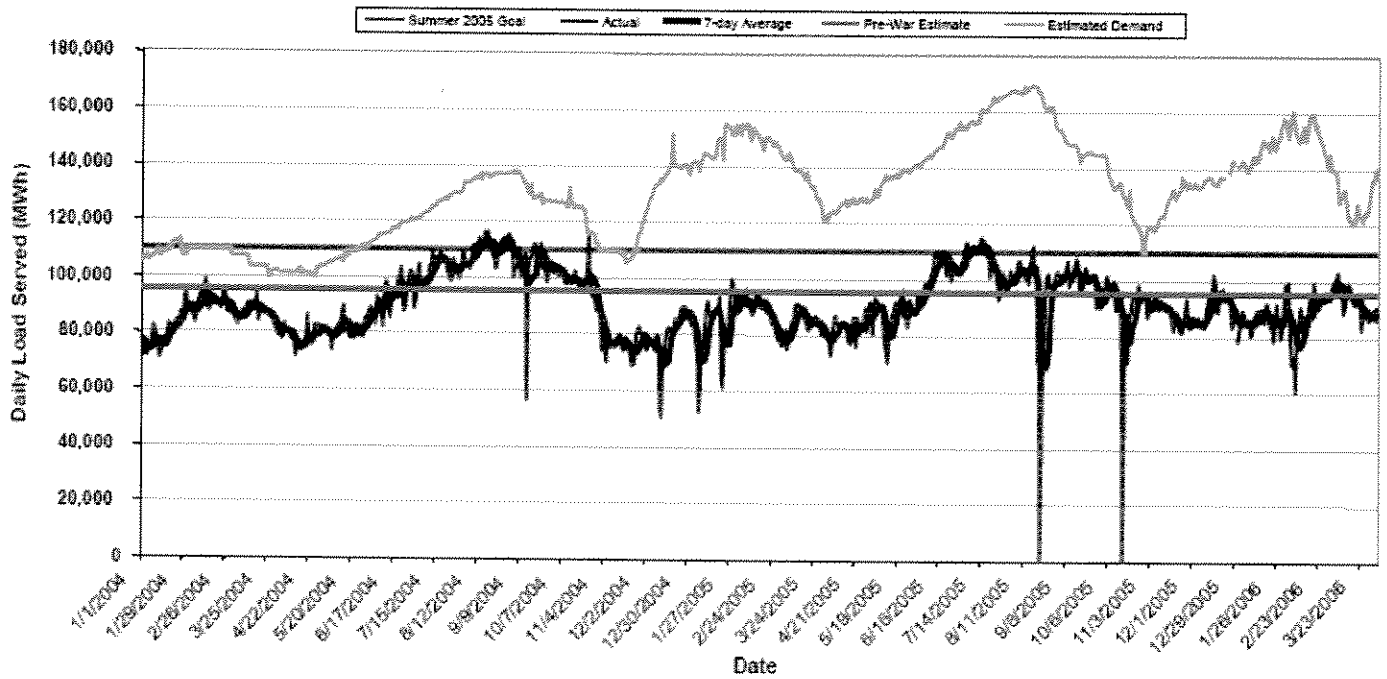


Source: Department of State.

Note: March data as of March 24, 2006

In the electricity sector, production has largely fallen short of the original target goal of producing 120,000 megawatt-hours of electricity per day. In May 2005, agency reports show this target goal was reduced to 110,000 megawatt-hours. As shown in figure 5, this target goal was last reached briefly in the early summer of 2005 and has not been met since. In March 2006, about 89,000 megawatt-hours was produced. Agency reports have attributed the downward spikes in production to several causes, including planned and unplanned maintenance, fuel shortages due to insurgent attacks on oil pipeline that supply fuel to power plants, and limited supply of fuels.

Figure 5: Estimated Daily Electricity Produced in Iraq, January 1, 2004-March 23, 2006



Source: Department of State.

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Further, supply has not improved much over last year when judged by hours of power. According to agency reporting, the national average of available electricity was 12.3 hours per day in the last week of February, 2006, and 11.7 hours per day last week of March. The average for Baghdad was 8.1 hours per day in February 2006, and 5.7 hours per day in March 2006. According to agency reporting, Iraqis have become greater consumers and this had dramatically altered demand and diluted the effect of increased generation capacity on actual results

Security Conditions Have Hindered Reconstruction Efforts

The security situation in Iraq has also affected the cost and schedule of reconstruction efforts. Security conditions have, in part, led to project delays and increased costs for security services. Although it is difficult to quantify the costs and delays resulting from poor security conditions, both agency and contractor officials acknowledged that security costs have diverted a considerable amount of reconstruction resources and have led to canceling or reducing the scope of some reconstruction projects. In January 2006, State reported that direct and indirect security costs represent 16 to 22 percent of the overall cost of major infrastructure reconstruction projects.<sup>11</sup> In addition, the security environment in Iraq has led to severe restrictions on the movement of civilian staff around the country and reductions of a U.S. presence at reconstruction sites, according to U.S. agency officials and contractors. For example, in February 2006 the Project Contracting Office reported that in October 2005 the number of attacks on convoys and casualties had increased from 20 convoys attacked and 11 casualties compared with 33 convoys attacked and 34 casualties in January 2006.

Project Management Challenges Also Affect U.S. Reconstruction Program

While poor security conditions have slowed reconstruction and increased costs, a variety of management challenges also have adversely affected the implementation of the U.S. reconstruction program. In September 2005, we reported that management challenges such as low initial cost estimates and delays in funding and awarding task orders have led to the reduced scope in the water and sanitation program and delays in starting projects. In addition, U.S. agency and contractor officials have cited difficulties in initially defining project scope, schedule, and cost, as well as concerns with project execution, as further impeding progress and increasing program costs. These difficulties include lack of agreement among U.S. agencies, contractors, and Iraqi authorities; high staff turnover; an

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<sup>11</sup>Department of State, Report to Congress, Section 2207 Report on Iraq Relief and Reconstruction, January 2006.



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Iraq's Capacity to Operate and  
Maintain U.S.-Funded Projects  
Presents Sustainability  
Problems

inflationary environment that makes it difficult to submit accurate pricing; unanticipated project site conditions; and uncertain ownership of project sites. Further, between Jan 2004 and April 2006, the Administration reallocated \$3.5 billion from the water and electricity sectors to security, justice, democracy and other programs which contributed to the cancellation and delays of water and electricity projects.

The U.S. reconstruction program has encountered difficulties with Iraq's ability to sustain the new and rehabilitated infrastructure and address maintenance needs. In the water, sanitation, and electricity sectors, in particular, some projects have been completed but have sustained damage or become inoperable due to Iraq's problems in maintaining or properly operating them. State reported in January 2006 that several efforts were under way to improve Iraq's ability to sustain the infrastructure rebuilt by the United States.

- In the water and sanitation sector, U.S. agencies have identified limitations in Iraq's capacity to maintain and operate reconstructed facilities, including problems with staffing, unreliable power to run treatment plants, insufficient spare parts, and poor operations and maintenance procedures. In March 2005, State reallocated funding from an electrical generation project and provided \$25 million to USAID to support the operations, maintenance, and logistics for USAID's reconstructed water and sanitation projects for up to 1 year. According to a senior IRMO official, the U.S. government has allocated an additional \$110 million to the Project Contracting Office to sustain water and sanitation facilities and equipment that were procured, constructed, or rehabilitated using IRRF monies. The program, expected to begin soon after the USAID effort ends in April 2006, will consist of two major components—operations and maintenance support and assistance and capacity development. The objectives of the program are to effectively operate U.S. government-funded facilities in the near term and to help the Iraqi government sustain these efforts over the long-term.
- The U.S. government purchased 41 natural gas turbines to support Iraq's efforts to generate more electricity, but Iraqi power plants are using fuel oil for all these engines due to limited access to natural gas. The use of oil-based fuels, without adequate equipment modification and fuel treatment, decreases the power output of the gas turbines by up to 50 percent, requires three times more maintenance, and could result in equipment failure and damage that significantly reduce the life of the equipment, according to U.S. and Iraqi power plant officials. IRMO estimates that the

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yearly cost of operating these turbines with oil-based fuels instead of natural gas totals \$1.25 billion.<sup>12</sup> If Iraq were able to capture the gas it currently flares and use it in these turbines, IRMO estimates that the annual operating cost would be about \$81.8 million. However, this latter cost does not include initial capital expenditures for the infrastructure needed to collect and process the natural gas and transport it to the power plants. In addition, the IRMO analysis assumes that the cost of natural gas is zero since this gas is currently flared in Iraq's oil fields. These cost comparisons will be analyzed in more detail as part of our ongoing review of Iraq's energy sector.

- The Iraqis' capacity to operate and maintain the power plant infrastructure and equipment provided by the United States remains a challenge at both the plant and ministry levels. As a result, the infrastructure and equipment remain at risk of damage following their transfer to the Iraqis. U.S. officials have acknowledged that more needs to be done to train plant operators and ensure that advisory services are provided after the turnover date. In January 2006, State reported that it has developed a strategy with the Ministry of Electricity to focus on rehabilitation and sustainment of electricity assets.

Problems with the turnover of completed projects, such as those in the water and sanitation and electricity sectors, have led to a greater interagency focus on improving project sustainability and building ministry capacity. In January 2006, State reported that it has several efforts under way focused on improving Iraq's ability to operate and maintain facilities over time. As part of our ongoing review of Iraq's energy sector, we will be assessing the extent to which the administration is providing funds to sustain the infrastructure facilities constructed or rehabilitated by the United States.

Limited Performance Data and Measures and Inadequate Reporting Present Difficulties in Determining Progress and Impact of Rebuilding Effort

While State has set broad goals for providing essential services, and the U.S. program has undertaken many rebuilding activities in Iraq, limited performance data and outcome measures make it difficult to determine and report on the progress and impact of U.S. reconstruction. In January 2006, State reported that it is currently finalizing a set of metrics to better track the impact of reconstruction efforts.

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<sup>12</sup>Total annual operating costs by type of oil used: (1) \$228 million for crude oil in 4 turbines; (2) \$206 million for residual oil in 20 turbines; and (3) \$819 million for diesel oil in 17 turbines. IRMO based these calculations on International Standards Organization rated capacity in megawatts for each engine.

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In the water and sanitation sector, the Department of State has primarily reported on the numbers of projects completed and the expected capacity of reconstructed treatment plants. However, we found that the data are incomplete and do not provide information on the scope and cost of individual projects nor do they indicate how much clean water is reaching intended users as a result of these projects. Moreover, reporting only the number of projects completed or under way provides little information on how U.S. efforts are improving the amount and quality of water reaching Iraqi households or their access to sanitation services. For example, the United States reports that, as of March 2006, Iraq has the capacity to produce 1.1 million cubic meters of water per day. However, this level overestimates the amount of potable water reaching Iraqi households because U.S. officials estimate that 60 percent of water treatment output is lost due to leakage, contamination, and illegal connections. In addition, potable water and sewage lines in Iraq are sometimes adjacent to each other, allowing leaking sewage to enter the water mains when there is insufficient pressure in the lines. In the absence of metering and quality measures, it is unclear how U.S. efforts are improving Iraqi access to water and sanitation services.

Limitations in health sector measurements also make it difficult to relate the progress of U.S. activities to its overall effort to improve the quality and access of health care in Iraq. Department of State measurements of progress in the health sector primarily track the number of completed facilities, an indicator of increased access to health care. However, the data available do not indicate the adequacy of equipment levels, staffing levels, or quality of care provided to the Iraqi population. Monitoring the staffing, training, and equipment levels at health facilities may help gauge the effectiveness of the U.S. reconstruction program and its impact on the Iraqi people.

In the electricity sector, U.S. agencies have primarily reported on generation measures such as levels of added or restored generation capacity and daily power generation of electricity; numbers of projects completed; and average daily hours of power. However, these data do not show whether (1) the power generated is uninterrupted for the period specified (e.g., average number of hours per day); (2) there are regional or geographic differences in the quantity of power generated; and (3) how much power is reaching intended users. Information on the distribution

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and access of electricity is difficult to obtain without adequate security or accurate metering.

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## Iraq Faces Challenges in Financing Future Needs

As the new Iraqi government forms, it must plan to secure the financial resources it will need to continue the reconstruction and stabilization efforts begun by the United States and international community. Initial assessments in 2003 identified \$56 billion in reconstruction needs across a variety of sectors in Iraq. However, Iraq's needs are greater than originally anticipated due to severely degraded infrastructure, post-conflict looting and sabotage, and additional security costs. The United States has borne the primary financial responsibility for rebuilding and stabilizing Iraq; however, its commitments are largely obligated and remaining commitments and future contributions will focus on sustaining rebuilt infrastructure, building government institutions, and training and equipping Iraqi security forces. Further, U.S. appropriations were never intended to meet all Iraqi needs. International donors have provided a lesser amount of funding for reconstruction and development activities; however, most of the pledged amount is in the form of loans that Iraq has just begun to access. Iraq's ability to contribute financially to its additional rebuilding and stabilization needs is dependent upon the new government's efforts to increase revenues obtained from crude oil exports, and reduce expenditures.

**Iraqi needs are greater than originally anticipated.** Initial assessments of Iraq's needs through 2007 by the U.N., World Bank, and the CPA estimated that the reconstruction of Iraq would require about \$56 billion.<sup>13</sup> However, Iraq is likely to need more funding than currently available to meet the demands of the country. The state of some Iraqi infrastructure was more severely degraded than U.S. officials originally anticipated or initial assessments indicated. The condition of the infrastructure was further exacerbated by post-2003 conflict looting and sabotage. In addition, insurgents continue to target electrical transmission

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<sup>13</sup>The October 2003 joint UN/World Bank assessment identified \$36 billion, from 2004 through 2007, in immediate and medium-term needs in 14 priority sectors, including education, health, electricity, transportation, agriculture, and cross-cutting areas such as human rights and the environment. For example, the assessment estimated that Iraq would need about \$12 billion for rehabilitation and reconstruction, new investment, technical assistance, and security in the electricity sector. In addition, the assessment noted that the CPA estimated an additional \$20 billion would be needed from 2004 through 2007 to rebuild other critical sectors such as security and oil.

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lines and towers as well as oil pipelines that provide needed fuel for electrical generation.

Further, these initial assessments assumed that Iraqi government revenues and private sector financing would increasingly cover long-term reconstruction requirements. This was based on the assumption that the rate of growth in oil production and total Iraqi revenues would increase over the next several years. However, private sector financing and government revenues may not yet meet these needs. According to a January 2006 International Monetary Fund (IMF) report, private sector investment will account for 8 percent of total projected investment for 2006, down from 12 percent in 2005.<sup>14</sup> In the oil sector alone, Iraq will likely need an estimated \$30 billion over the next several years to reach and sustain an oil production capacity of 5 million barrels per day, according to industry experts and U.S. officials. For the electricity sector, Iraq projects that it will need \$20 billion through 2010 to boost electrical capacity, according to the Department of Energy's Energy Information Administration.

**Future contributions for Iraq reconstruction may be limited.** The United States is the primary contributor to rebuilding and stabilization efforts in Iraq. Since 2003, the United States has made available about \$30 billion for activities that have largely focused on infrastructure repair and training of Iraqi security forces. As of January 2006, of the \$30 billion appropriated, about \$23 billion had been obligated and about \$16 billion had been disbursed for activities that included infrastructure repair, training, and equipping of the security and law enforcement sector; infrastructure repair of the electricity, oil, and water and sanitation sectors; and CPA and U.S. administrative expenses.

International donors have provided a lesser amount of funding for reconstruction and development activities. According to State, donors have provided about \$2.7 billion in multilateral and bilateral grants—of the pledged \$13.6 billion—as of December 2005. About \$1.3 billion has been deposited by donors into the two trust funds of the International

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<sup>14</sup>International Monetary Fund, *Iraq: Request for Stand-by-Arrangement* (Washington, D.C.: January 2006).

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Reconstruction Fund Facility for Iraq (IRFFI),<sup>15</sup> of which about \$900 million had been obligated and about \$400 million disbursed to individual projects, as of December 2005. Donors also have provided bilateral assistance for Iraq reconstruction activities; however, complete information on this assistance is not readily available. Most of the pledged amount is in the form of loans that the Iraqis have recently begun to access. About \$10 billion, or 70 percent, of the \$13.6 billion pledged in support of Iraq reconstruction is in the form of loans, primarily from the World Bank, the IMF, and Japan.

**Iraq must address budget constraints to contribute to future rebuilding and stabilization efforts.** Iraq's fiscal ability to contribute to its own rebuilding is constrained by the amount of revenues obtained from crude oil exports, continuing subsidies for food and energy, growing costs for government salaries and pensions, increased demands for an expanding security force, and war reparations and external debt.

Crude oil exports are projected to account for nearly 90 percent of the Iraqi government revenues in 2006, according to the IMF. Largely supporting Iraq's government operations and subsidies, crude oil export revenues are dependent upon export levels and market price. The Iraqi 2006 budget has projected that Iraq's crude oil export revenues will grow at an annual growth rate of 17 percent per year (based on an average production level of 2 million bpd in 2005 to 3.6 million bpd in 2010), estimating an average market price of about \$46 per barrel. Oil exports are projected to increase from 1.4 million bpd in 2005 to 1.7 million bpd in 2006, according to the IMF. Iraq's current crude oil export capacity is theoretically as high as 2.5 million bpd, according to the Energy Information Administration at the Department of Energy. However, Iraq's crude oil export levels have averaged 1.4 million bpd as of December 2005, in part due to attacks on the energy infrastructure and pipelines. In February 2006, crude oil export levels averaged about 1.5 million bpd.

While Iraq produces crude oil, its efforts to produce refined fuel products, such as diesel and gasoline, is limited. According to State, the Iraqi Oil Ministry imported roughly \$500 million of fuel each month in 2005. As a

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<sup>15</sup>The IRFFI was established in response to the June 24, 2003, UN technical meeting and the 2003 Madrid conference's calls for a mechanism to channel and coordinate donor resources for Iraq reconstruction and development activities. The IRFFI is composed of two trust funds, one run by the UN Development Group and the other by the World Bank Group.

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result, Iraq must import fuel to meet domestic demand. According to State, the imported fuel is sold at a subsidized price, further constraining Iraqi budgetary resources.

Current government subsidies constrain opportunities for growth and investment and have kept prices for food, oil, and electricity low. Low prices have encouraged over-consumption and have fueled smuggling to neighboring countries. Food and energy subsidies account for about 8 percent of Iraq's projected gross domestic product (GDP) for 2006.

As part of its Stand-By Arrangement with the IMF, Iraq plans to reduce the government subsidy of petroleum products, which would free up oil revenues to fund additional needs and reduce smuggling. According to the IMF, by the end of 2006, the Iraqi government plans to complete a series of adjustments to bring fuel prices closer to those of other Gulf countries. However, it is unclear whether the Iraqi government will have the political commitment to continue to raise fuel prices. The scheduled March increase in the price of diesel and gasoline was delayed until June 2006. Iraqis currently pay about \$.26 per gallon for regular gasoline compared to about \$.91 per gallon in neighboring countries.

Generous wage and pension benefits have added to budgetary pressures. Partly due to increases in these benefits, the Iraqi government's operating expenditures are projected to increase by over 24 percent from 2005 to 2006, according to the IMF. As a result, wages and pensions constitute about 21 percent of projected GDP for 2006. The IMF noted that it is important for the government to keep non-defense wages and pensions under firm control to contain the growth of civil service wages. Under the IMF agreement, the Iraqi government must complete a census of all public service employees by June 2006. The census will help address the issue of ghost employees in Iraqi ministries—employees on the payroll but not working, according to a U.S. Treasury official.

Iraq plans to spend more resources on its own defense. Iraq's security-related spending is currently projected to be about \$5.3 billion in 2006, growing from 7 to about 13 percent of projected GDP. The amount reflects rising costs of security and the transfer of security responsibilities from the United States to Iraq.

The Iraqi government also owes over \$84 billion to victims of its invasion of Kuwait and international creditors. As of December 2005, Iraq owed

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about \$33 billion in unpaid awards resulting from its invasion and occupation of Kuwait. As directed by the UN, Iraq currently deposits 5 percent of its oil proceeds into a UN compensation fund. Final payment of these awards could extend through 2020 depending on the growth of Iraq's oil proceeds. In addition, the IMF estimated that Iraq's external debt was about \$51 billion at the end of 2005.

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## Conclusion

Iraq is at a precarious stage in its emerging democracy and 2006 will be a critically important year in its development. Continuing insurgent violence and growing sectarian divisions make it increasingly difficult to achieve the ultimate U.S. goal of a united and stable Iraq that is well integrated into the international community and a full partner in the global war on terrorism. The United States, Iraq, and our international partners face daunting challenges in achieving this goal and making a difference in lives of the Iraqi people. These include forming a national unity government, quelling the insurgency and sectarian violence, providing basic services, and financing future reconstruction efforts.

In moving forward, the United States must continue to train and equip Iraqi security forces and, more importantly, ensure that these forces have the logistical capabilities to support and sustain themselves. The United States along with the international community must also help Iraqis develop the budgeting and administrative tools they need to run their national and provincial governments. Additionally, transparency and accountability mechanisms are essential given the legacy of corruption inherited from the previous regime. Efforts must also be taken to ensure that Iraqis are capable of maintaining power plants, water treatment facilities, and other U.S.-funded infrastructure.

Although the United States has played a key role in addressing these challenges, it is important for the Iraqis to assume greater leadership and for the international community to increase its efforts. In assuming leadership, the Iraqis need to form a permanent government and address unresolved constitutional and budgetary issues. Of particular importance is disbanding the militias, reducing subsidies, and controlling a bloated bureaucracy. Even as they address these difficult challenges, Iraq must reengage the international community to fund the enormous reconstruction tasks that remain. This will not be easy since donors are



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demanding accountability for funding they have provided over the past 3 years.

Collectively, Iraq's future requires strong Iraqi leadership, sustained U.S. commitment, and a reengaged international community. All these will be essential in order for real success to be achieved.

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Mr. Chairman and Members of the Subcommittee, this concludes my prepared statement. I will be happy to answer any questions you may have.

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## GAO Contacts and Acknowledgments

For questions regarding this testimony, please call Joseph Christoff at (202) 512-8979. Other key contributors to this statement were Monica Brym, Lynn Cothorn, Dave Groves, Patrick Hickey, Steve Lord, Micah McMillan, Judy McCloskey, Tet Miyabara, Kate Monahan, Mary Moutsos, and Audrey Solis. Jeanette Espinola, Ian Ferguson, Valerie Nowak, Jeff Phillips, and Nanette Ryen provided technical assistance.

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